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April 17, 2009

By Hand Delivery

Honorable Kristi Izzo, Secretary
New Jersey Board of Public Utilities
Two Gateway Center
Newark, NJ 07102

**Re: In the Matter of the Petition of New Jersey American Water Company
for Authorization to Implement a Distribution System Improvement
Charge ("DSIC")
BPU Docket No. WO08050358**

Dear Secretary Izzo:

Enclosed please find an original and ten copies of the Initial Brief of the Department of the Public Advocate, Division of Rate Counsel in connection with the above referenced matter. Copies of the brief are being provided to all parties by electronic mail, and hand delivery or overnight mail. Commissioner Frederick F. Butler, the designated hearing officer in this case, is also being provided with a copy.

Please stamp and date the extra copy as "filed" and return it to our courier.

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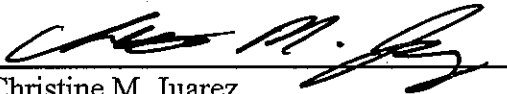
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Respectfully submitted,

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I/M/O Joint Petition of New Jersey
American Water Company for
Authorization to Implement a
Distribution System Improve Charge
("DSIC")
BPU Docket No. WO08050358
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**Receives all correspondence except
discovery.*

**BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES**

**IN THE MATTER OF THE PETITION :
OF NEW JERSEY AMERICAN WATER :
COMPANY FOR AUTHORIZATION : BPU Docket No. WO08050358
TO IMPLEMENT A DISTRIBUTION :
SYSTEM IMPROVEMENT CHARGE :**

**INITIAL BRIEF OF THE
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE,
DIVISION OF RATE COUNSEL**

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STATEMENT OF FACTS AND PROCEDURAL HISTORY

On May 23, 2008, New Jersey American Water Company (“New Jersey American” or the “Company”) filed a petition requesting authorization to implement a Distribution System Improvement Charge (“DSIC”). The DSIC would impose self implementing, automatic rate increases to customer bills each calendar quarter to recover the costs for certain DSIC-eligible water and sewer system capital improvements. DSIC is a novel proposal which uses single-issue ratemaking to allow New Jersey American to earn a return of and on its investment through the DSIC adjustment clause. The DSIC will be applied as a percentage of each customer’s bill and that percentage will not exceed 7.5% of the Company’s gross revenues, exclusive of DSIC charges, from the prior year. When New Jersey American files a base rate case, the capital improvements in the DSIC will be incorporated into Utility Plant in Service, the DSIC will reset to zero in the rate case, and then after the rate case, increase again until the Company’s next rate case. The Company proposes an annual filing in which the provisional rates from the previous year will become permanent DSIC rates, and for authority to make quarterly DSIC filings the following year.

New Jersey American is a utility that provides water service to more than 606,500 customers in the State of New Jersey. New Jersey American also provides wastewater service to approximately 28,400 customers in New Jersey. New Jersey American is a subsidiary of American Water Works Company, Inc. The Company’s water and wastewater customers are located in various municipalities in Atlantic, Burlington,

Camden, Cape May, Essex, Gloucester, Hunterdon, Middlesex, Mercer, Monmouth, Morris, Ocean, Passaic, Salem, Somerset, Union and Warren Counties.

With their petition the Company filed direct testimony from witnesses H. Edward Rex, Suzanne G. Chiavari and W. Andrew Clarkson. On July 15, 2008, a motion to intervene was filed on behalf of the New Jersey Chapter of the National Association of Water Companies (“NAWC”). On July 17, 2008 a motion to intervene was also filed on behalf of Cogen Technologies Linden Venture, L.P. (“Cogen”). An order granting intervention to both NAWC and Cogen was issued by the Board of Public Utilities, (“BPU” or the “Board”) on October 6, 2008. The October 6, 2008 Board order also designated the Honorable Commissioner Frederick F. Butler as the presiding officer over the DSIC proceedings. On January 13, 2009 the Mount Laurel Township Municipal Utilities Authority, the Evesham Municipal Utilities Authority, the Monroe Township Water Municipal Utilities Authority, the Township of Haddonfield and the Township of Moorestown (the “Bulk Purchasers”) jointly filed a motion for intervention. A Board order granting intervention to the Bulk Purchasers was issued by the BPU on February 11, 2009. The parties in the case also include the Department of the Public Advocate, Division of Rate Counsel (“Rate Counsel”) and the Staff of the Board of Public Utilities (“Staff”).

The Parties conducted discovery during the next several months. Public hearings were held on January 6, 2009 at 2:00 p.m. at the Maplewood Library, January 6, 2009 at 7:00 p.m. at the Howell Memorial Middle School, January 8, 2009 at 2:00 p.m. at the Westfield Memorial Library and January 8, 2009 at 7:00 p.m. at the Westhampton Municipal building.

On January 9, 2009, direct testimony was filed on behalf of Rate Counsel by expert witnesses Robert Henkes and Howard Woods. Direct testimony was filed on behalf of the NAWC by witnesses Mark A. Gennari, A. Bruce O'Connor and William C. Packer. On February 6, 2009, rebuttal testimonies were filed on behalf of the Company by witnesses Rex and Chiavari. In their rebuttal testimony, Mr. Rex and Ms. Chiavari revised the Company's DSIC proposal. The new proposal reduced the types of plant that would be DSIC- eligible. PRT-1 at DSIC Matrix attachment.¹ The new proposal moved a determination of prudence from the annual DSIC filing to the Company's next base rate case, and reduced the Company's proposed earnings cap from the Company's authorized return on equity plus 200 basis points, to the authorized return on equity plus 100 basis points. PRT-1 at 5, 11. The Company also revised the proposed earnings test to utilize the Company's average common equity balance. PRT-1 at 11. The new proposal also develops separate water and wastewater charges, and eliminates interest on DSIC under-collections. PRT-1 at 16, and DSIC Matrix attachment. On February 9, 2009, joint rebuttal testimony was filed on behalf of the NAWC by witnesses Gennari, O'Connor and Packer. The NAWC offered rebuttal testimony on what the NAWC would like to see in a generic DSIC, and responded to arguments raised in initial testimony by Rate Counsel. Evidentiary Hearings were held at the BPU on March 4 and 6, 2009 before Commissioner Butler. Rate Counsel witnesses Mr. Henkes and Mr. Woods presented oral surrebuttal at the hearings, as did Ray Makul on behalf of the Bulk Purchasers.

¹ The Direct and Rebuttal Testimonies of Edward Rex were admitted into evidence as PT-1 and PRT-1, respectively. The Direct and Rebuttal Testimonies of Suzanne Chiavari were admitted into evidence as PT-2 and PRT-2, respectively. The Direct Testimony of Howard Woods was admitted into evidence as RC-1, and the Direct Testimony of Robert Henkes was admitted into evidence as RC-25.

ARGUMENT

I. NEW JERSEY AMERICAN HAS NOT MET ITS BURDEN OF PROVING THAT A DSIC IS NEEDED TO MAINTAIN ITS INFRASTRUCTURE AND CONTINUE PROVIDING SAFE, ADEQUATE AND PROPER SERVICE TO ITS RATEPAYERS UNDER TRADITIONAL RATEMAKING PRINCIPLES.

In New Jersey regulated utilities such as New Jersey American have traditionally received rate increases by filing base rate cases before the Board. In a base rate case, a utility's revenues, expenses, rate base, and capital structure are examined within a defined test period. Under a traditional ratemaking process, the Board sets rates on a cost of service basis, by employing an approach that looks at a utility's capital investments, revenues, and expenses, including a fair rate of return, to determine required revenues. Indeed, the New Jersey Supreme Court has stated that the "three primary factors involved in the determination of justness and reasonableness of rates are an examination of a company's property valuation which constitutes its rate base, its expenses and the rate of return developed by relating its income to its rate base." *I/M/O New Jersey Power & Light Co. v. Bd. of Pub. Util.*, 9 N.J. 498, 508 (1952). Traditional utility ratemaking captures all revenue increases, expense decreases, and cheaper financing that has occurred since the utility's previous base rate case. This approach works to the benefit of ratepayers by offsetting any revenue requirement increase that may be needed. This concept of examining all components that compose the revenue requirement is known as the "matching" principle. As expert witness Mr. Henkes testified, the matching principle is a very important part of proper ratemaking. Testimony of Robert Henkes at 6, admitted into the record as RC-25 ("RC-25").

A DSIC is novel in that it involves single-issue ratemaking for capital additions, on which the Company would earn a return of and on its investment. A DSIC does not adhere to the principles of traditional utility ratemaking. A DSIC is an adjustment clause. Adjustment clauses represent single-issue ratemaking. In single-issue ratemaking, the adjustment clause is set up to collect certain costs – which in the case of DSIC are the return of and on DSIC-eligible capital additions - without examining all components of the utility’s revenue requirement. Single-issue ratemaking is an extraordinary remedy. Accordingly, the Board has invoked single-issue ratemaking with caution and has limited the use of adjustment clauses to situations involving very large expenses on which a utility earns no profit, that are outside of the utility’s control, and are subject to volatility. For example, the Levelized Energy Adjustment Clause (“LEAC”) involves a pass-through of electric commodity prices, which are volatile and, since restructuring, purchased from third-party suppliers. Likewise, the Purchased Water Adjustment Clause (“PWAC”) and Purchased Sewer Treatment Adjustment Clause (“PSTAC”) collect a utility’s expense of purchasing water or sewer treatment from other parties. Not only does the water or sewer utility earn no profit on this expense, but the expense is volatile and largely outside of the control of the utility. Only in such limited circumstances has the Board authorized rate recovery through single-issue ratemaking. RC-25 at 12; *see, e.g., I/M/O Pub. Serv. Elec. & Gas Co. For Approval of an Increase in Elec. & Gas Rates*, BPU Dkt. No. 744-335, Order dated 10/31/75, at p. 3 (in adopting a Raw Materials Adjustment Clause, which passed through PSE&G’s cost of purchasing natural gas from suppliers, the Board noted the purpose of the clause was to stabilize fuel costs and

“curtail the wide variation in gas bills from month to month which is a source of consumer frustration and confusion.”)

As Mr. Henkes testified, rates are normally set in the context of a base rate case where all the ratemaking components in a defined test period are examined simultaneously. RC-25 at 6-7. While some costs naturally increase, a traditional base rate case also captures all decreases which help offset any rate increase. Mr. Henkes testified that this concept of “matching” all components in the ratemaking formula is an integral part of proper ratemaking. RC-25 at 6. The Company’s proposed DSIC violates this matching principle because it allows automatic rate increases for one item - a return of and return on DSIC-eligible capital additions – without examining all of New Jersey American’s revenue requirement components.

In addition, the costs to be collected under the proposed DSIC do not adhere to the limited circumstances for which the Board authorizes single-issue ratemaking. As Mr. Henkes testified, “[a]djustment clauses such as the proposed DSIC rate mechanism are formula rates that set up the elements of cost to be collected under the rate. The purpose of an adjustment clause is to guarantee rate recovery for the particular ratemaking element for which the clause was set up.” RC-25 at 11.

Here, the Company’s asset management program is not outside its control, but is planned and controlled by management. Moreover, as Mr. Henkes testified, the Company has not provided evidence that the DSIC-eligible capital additions are subject to price volatility or that they would have a significant financial impact on the Company. RC-25 at 12. Furthermore, the Board has only allowed adjustment clauses when a particular expense constitutes a large portion of a company’s revenue requirement. The

DSIC in this case does not satisfy this requirement. The amount of DSIC eligible plant constructed each year is small with respect to the Company's overall investment budget. As Mr. Woods testified, New Jersey American's expenditures on DSIC-eligible plant represent only approximately 27% of the Company's annual construction expenditures. RC-1 at 26. Although the Company has proposed that the DSIC surcharge will not exceed 7.5% of a customer's bill, the Company's testimony indicates that the DSIC charge will not approach that cap. Ms. Chiavari testified that New Jersey American spends on average approximately \$35.6 million annually on DSIC-eligible projects, and plans to double this amount if given a DSIC. PT-2 at 18. The Company has stated that a DSIC will not affect the frequency of its base rate filings. RC-6. Given that New Jersey American files a rate case approximately every two years, DSIC would represent at most only 3% to 4% of the Company's overall revenue requirement. PT-1, Schedule A. DSIC-eligible investments simply don't affect the Company's bottom line to an extent that warrants single-issue ratemaking. Thus, New Jersey American has not shown that the circumstances here warrant implementation of a DSIC.

As the petitioner in this matter, New Jersey American bears the burden of proving to the Board that implementation of a DSIC is necessary and proper. *In Re Pub. Serv. Elec. & Gas Co.*, BPU Docket No. EO96010028, 170 PUR4th 334, 347 (June 21, 1996). The evidentiary record in this matter is replete with testimony from the Company explaining the specifics of what a potential DSIC may look like, and comparisons of DSIC mechanisms implemented in other states. While the evidence put forth by New Jersey American describes what the Company seeks, the evidence falls short in proving

that a DSIC mechanism for cost recovery outside the utility's basic revenue requirement is warranted.

The Company never proves that a DSIC is necessary to continue the provision of safe, adequate and proper service to its customers. Nor does the Company claim that it cannot properly maintain its infrastructure by earning a return on its investments through the current, traditional rate case structure. This is also echoed by Rate Counsel expert witness Mr. Henkes, who testified during evidentiary hearings, "New Jersey American has not proven that its company needs a DSIC to maintain safe, adequate, and proper service nor has it proven that recovery of its capital investment program cannot be accomplished through traditional rate-making." 28T:L7-11 (3/6/09). Rather, the crux of New Jersey American's argument is that New Jersey American needs to accelerate investment in its infrastructure, and a DSIC would provide the Company with an incentive to accelerate such investment. As Company witness Suzanne Chiavari testified:

Currently, NJAWC seeks recovery of these infrastructure replacement costs through its rate case filings....This work is ongoing, but a project can be planned and designed several years ahead of when it is recognized in rates. The result is that the current regulatory frame work creates a financial disincentive to investing the massive levels of capital needed to address the issues faced by the industry, as well as implementing the work in a more regularly-scheduled, regionally coordinated fashion. Additionally, since the main replacement referred to above is simply replacing the main located in front of our existing customers, NJAWC is not receiving any additional revenues associated with this main replacement. Thus, the Company is funding 100% of the investment and not receiving any return on this investment until it is approved and included in a future rate case proceeding. Testimony of Suzanne Chiavari, at 14-15, admitted into the record as PT-2 ("PT-2").

As illustrated above, New Jersey American seeks Board approval to implement a DSIC in order to minimize its financial risk and essentially eliminate any drag on earnings from its infrastructure investments. The Company's reasoning is not sufficiently compelling to justify the implementation of a DSIC, which is an extraordinary remedy that will burden ratepayers with increased bills every three months.

As a regulated utility, New Jersey American has an obligation to provide safe, adequate and proper service to its customers. N.J.S.A. 48:2-23. Investing in its infrastructure is part of the Company's obligation as a utility monopoly. The Company is financially protected and compensated for such investments through the current rate setting framework in New Jersey. Accordingly, the Company should not need a special incentive to invest in its infrastructure, and investing in aging infrastructure does not qualify as an extraordinary service to ratepayers. Mr. Henkes noted this point in his testimony:

The Regulatory Compact under which the Company is operating requires that the Company must provide, and the ratepayers must fund, safe, adequate and proper water and sewer service at the lowest possible cost in exchange for having received a monopoly franchise....It is obvious that when an old pipe is replaced with a new pipe, one could claim that a benefit has been achieved in the form of potentially reduced main breaks and service interruptions. However, such a pipe replacement does not represent an extraordinary act by NJAWC beyond the call of its normal duty under the Compact. There is nothing so extraordinary about such a pipe replacement under the DSIC that would qualify the investment as an "extra" benefit to the ratepayers, particularly given that the ratepayers are paying for 100% of the investment and that the Company expects the ratepayers to pay a return on the investment that is 200 basis point[s] in excess of NJAWC's current authorized rate of return.

RC-25 at 14-15.

Concomitantly, the Company is required to properly maintain its infrastructure as a requirement of its monopoly franchise and it is unnecessary that the Board grant to New

Jersey American a special rate recovery clause to do something that the Company is already required to do.

Additionally, approval of a DSIC for New Jersey American is premature. New Jersey American's assertion that it faces massive capital expenditures and needs to accelerate capital spending requires vetting by the Board, otherwise, ratepayers face the risk of paying for unnecessary capital spending during a period of economic crisis. During the evidentiary hearings, Rate Counsel witness Mr. Woods, a Professional Engineer, testified that he does not agree that New Jersey American needs to accelerate its infrastructure maintenance and repair program. 104T:L24 – 105T:L2 (3/6/09). Mr. Woods recommends that the Board should order a focused management audit of the Company's asset management program to address this issue. RC-1 at 28.

For the reasons set forth above, New Jersey American has not proven that it needs a DSIC to maintain safe, adequate and proper service for its customers and its request should be denied.

II. NEW JERSEY AMERICAN IS EARNING A REASONABLE RETURN ON ITS INVESTMENT.

One of the Company's main arguments for a DSIC is that the traditional ratemaking process results in a regulatory lag between rate cases. The term "regulatory lag" or "drag on earnings" represents the erosion of earnings opportunity caused by the passage of time between when a utility finishes construction on a project and when it receives recognition in rates. Ms. Chiavari testified that "[i]n developing our priorities, prudent management must also consider the effect of capital construction on the

company's financial picture. Delay in recovery thus acts as a disincentive to construction which might otherwise be done. The DSIC will eliminate this issue." PT-2 at 19. The Company's argument ignores the fact that when the Board sets a utility's return on equity in a base rate case, the Board factors the regulatory lag into its determination. If New Jersey American has no regulatory lag, there is little justification for New Jersey American's currently authorized equity return rate of 10.3%. A potential regulatory lag is one business risk that utilities have always faced, and is not a sufficient reason for granting a DSIC. Mr. Henkes addressed this issue in testimony on behalf of Rate Counsel:

Regulation is not intended to be a mechanism whereby a utility is guaranteed dollar-for-dollar recovery of either its costs or a particular level of profit and rate of return....By proposing the DSIC rate mechanism, the Company has completely disregarded the foundation upon which the regulatory process was developed, that is, that regulation is supposed to be a substitute for competition. This principal of regulation was designed to stimulate a utility to act as it would if it were in a competitive industry. Clearly, if a utility's rate of return is guaranteed, this represents a departure from traditional ratemaking foundations. Competitive entities do not have any such return guarantees. Regulation is intended to take the place of competition, therefore, regulated entities should not receive guaranteed recovery of their revenue requirement including a guaranteed rate of return if such guarantees are not available in the competitive marketplace.

RC-25 at 10.

It is also worthy to note that New Jersey American is earning a return on plant under construction between rate cases. This return is called AFUDC² (Allowance for Funds Used During Construction) and for New Jersey American this AFUDC earnings rate is equal to the Company's authorized rate of return. It is only when this construction ends and the plant goes into service that the AFUDC return will cease. However, at that

² The accrued AFUDC will be capitalized to plant and will be included as rate base plant investment in the Company's future base rate cases.

point the Company will also have additional revenues from customer growth and additional rate base deductions from growth in the depreciation reserve, contributions in aid of construction, customer advances and accumulated deferred income taxes. Thus any regulatory lag experienced by the Company between rate cases is minimized by these factors, and will end when the Board grants rate relief in the Company's base rate case. The AFUDC earnings, coupled with the fact that New Jersey American files base rate petitions about every two years, makes the regulatory lag experienced by the Company minimal. It is also important to note that not all money spent on DSIC-eligible capital investments is spent on the first day after the end of the Test Year in a rate case. The funds are spent over time. When a base rate case is concluded, the drag on earnings is very small.

Through the traditional ratemaking process, the Company is given adequate opportunity to earn a return on its prudently-made investments. This return, currently set at 10.3%, is an attractive return during these difficult economic times. Furthermore, New Jersey American received base rate increases of 15.19% in 2008, 12.46% in 2007, and approximately 10% in 2004. The Company is adequately compensated for distribution system related improvements under the current ratemaking scheme. New Jersey American should not be allowed to minimize its financial risk at ratepayer expense.

Rate Counsel also disagrees with the Company's claim that DSIC-eligible investments are non-revenue producing and therefore, the Company has little incentive to invest in them. PT-2 at 14-15. Rate Counsel witness Howard Woods has determined that almost all of the DSIC-eligible investments proposed by the Company have the potential to produce new revenues or reduce operating costs. RC-1 at 14-15. New Jersey

American is not offering to recognize these new revenues or reduced costs to offset the revenue requirement between rate cases. Mr. Woods testified to this very point:

nearly all of the items in this list have the potential to produce new revenues or reduce operating costs. In some instances, replacing existing water mains, valves or services can reduce leakage from the system. To the extent that real losses from the system are eliminated, the Company's source or [sic] supply, pumping and treatment expenses will be lowered incrementally....To the extent that tuberculated unlined cast iron mains are replaced or cleaned and relined, system pressures in the vicinity of such renovation work are likely to be improved during high demand conditions. Improved pressure can lead to higher customer use and this could mean added revenues for the Company. Meter replacements can also result in increased revenues.

Testimony of Howard Woods, at 15, admitted into the record as RC-1 ("RC-1").

Usually, when meters are replaced, they are replaced with devices that more accurately quantify the amount of water used by a customer. An older meter tends to run slow...My experience has been that they don't run fast.

112T:L7 - 14 (3/6/09).

New Jersey American is earning a reasonable return on its investment and its request for a DSIC should be denied.

III. THE SINGLE-ISSUE CHARACTERISTIC OF THE PROPOSED DSIC COULD LEAD TO OVER-EARNING BY NEW JERSEY AMERICAN, AND NEW JERSEY AMERICAN'S PROPOSED EARNINGS TEST FAILS TO PROTECT RATEPAYERS FROM THIS POSSIBILITY.

The single issue ratemaking aspect of a DSIC effectively increases rate base, by allowing the Company to earn a return of and on its investment, without corresponding offsets to rate base that are recognized in a base rate case. Indeed, Mr. Henkes provided examples of ratemaking components that have the potential to reduce New Jersey American's revenue requirement between rate cases, which the proposed DSIC ignores.

RC-25 at 7. Mr. Henkes testified that while the Company will receive a return of and on eligible plant additions under the DSIC proposal, there will be no recognition of the growth in New Jersey American's accumulated depreciation reserve, accumulated deferred income tax, and customer advances/contributions in aid of construction balances, all of which serve to reduce the Company's revenue requirement. RC-25 at 7-8. Moreover, by allowing automatic quarterly rate increases and practically negating any regulatory lag, the proposed DSIC would reduce the Company's business risk. Yet this fact would not be recognized with a corresponding decrease to the Company's return on equity. By disregarding the matching principle of traditional ratemaking, the Company's proposal could result in a higher achieved return on investment than would be permitted if all ratemaking components were considered in the context of a base rate case.

New Jersey American recognized this flaw in its own proposal (the potentiality of over-earning) and attempts to cure this defect by proposing an earnings test in its petition. However, the Company's proposed earnings test is a wholly inadequate remedy. In its petition the Company proposed an earnings cap that would allow the Company to earn a return on equity of 200 basis points above the return authorized by the Board in the Company's most recent base rate case. In other words, since the Company's authorized equity return is currently 10.3%, the Company would be allowed to earn an equity return rate of 12.3%. The Company recently modified its proposal to allow an equity return of 100 basis points above the currently authorized return, or 11.3%. The Company also made certain changes to its proposed earnings test. Both the original and modified proposals fail to protect ratepayers from paying for continuous over-earning between

base rate cases. As Mr. Henkes testified, the proposals ignore the Company's decreased business risk:

the Company has proposed that its stockholders be allowed to earn...over the return authorized by the Board in the Company's most recent base rate proceeding....The Company's return on equity is partially a function of the degree of earnings and business risk it experiences. As previously discussed, the proposed implementation of the DSIC will significantly reduce NJAWC's business risk in that the surcharge reduces the risk of regulatory lag and provides NJAWC with a reconcilable, dollar-for-dollar guaranteed revenue requirement recovery for a major portion of its between-rate case plant additions. This reduction in business risk should *reduce* and not *increase* NJAWC's return on equity requirement. RC-25 at 17 (emphasis in original).

Mr. Henkes also testified how the components of the modified earnings test fail to protect against the possibility of over-earning. The modified earnings test consists of two numbers: (1) the numerator, which is the Company's net income available for common equity in the DSIC Year and (2) the denominator, which is the Company's average common equity balance for the DSIC Year. RC-25 at 18; PRT at 11. The ratio of these two numbers produces a common equity rate, which would then be compared to the Company's authorized return on equity plus 100 basis points. Mr. Henkes testified to the many deficiencies inherent in this very simple earnings test. The net income and common equity balances used in this test include non-regulated and non-operating items that the Board always removes when determining the Company's Board authorized return on equity. RC-25 at 19. The Company also includes items in the net income and common equity balances that were either rejected by the Board in the Company's recent base rate case or are currently not considered for ratemaking purposes in New Jersey American base rate cases. Examples of such items are incentive compensation, donations, lobbying expenses, certain advertising expenses, public and community

relations expenses, Construction Work in Progress and associated AFUDC, and non-utility property. *Id.* The exercise of comparing the results of the modified earnings test to the Board's authorized equity return, as Mr. Henkes stated, "is like comparing apples to oranges and can result in very inaccurate conclusions." *Id.*

Furthermore, even if the Company's modified earnings test indicates that the Company is over-earning, the language of the Company's proposed DSIC tariff allows the Company to never issue a refund to customers. Referring to the proposed earnings cap, the Company's tariff language states that "[a]ny revenue that is not recovered as a result of this provision will be deferred." P-2 at 2. Mr. Henkes testified extensively about the effect of this tariff provision and the adverse impact on ratepayers during the evidentiary hearings:

I need to make note of something that you [New Jersey American] haven't discussed and that is this little obscure clause that is in your proposed tariff that is virtually impossible to understand and I issued a lot of data requests about that and the responses that came back from the company did not clear it up. And we, as you recall, had a teleconference where I had a meeting with the company where they again tried to explain it and it finally dawned on me what this little obscure clause actually means.

And what it means is as follows: When you're on an annual DSIC filing and you look ahead and you [New Jersey American] determine that you may over-recover in the annual filing, you would be allowed to bank certain DSIC eligible plant....that banked DSIC eligible investment, the company would then have an opportunity to put it in future DSIC rates when the company has determined that the DSIC year in that future DSIC case it's going to under-recover.

The bottom line on this whole little obscure clause is that the company will never ever over-recover and the ratepayers will never ever get one penny of refunds.

81T:L16 – 82T:L17 (3/6/09).

In summary, New Jersey American's DSIC proposal represents inappropriate single-issue making and does not adequately protect against the possibility of over-earning.

Strikingly, even if the Board determined that the Company over-recovered in a given DSIC year, the DSIC tariff would allow the Company to retain customers' money, for use in future years, instead of refunding customers the amount due to them. These are all reasons that justify the Board's denial of a DSIC to New Jersey American.

IV. GRANTING NEW JERSEY AMERICAN'S REQUEST FOR A DSIC COULD DISTORT THE COMPANY'S ASSET MANAGEMENT PROCESS.

While New Jersey American claims that a DSIC will eliminate its disincentive to invest in DSIC-eligible plant, the flip side of this argument is that a DSIC will give the Company an incentive to invest in DSIC-eligible plant over non DSIC-eligible plant. This could result in a distortion of the Company's capital planning process. This problem is illustrated by Ms. Chiavari's testimony on behalf of the Company: "In developing our priorities, prudent management must also consider the effect of capital construction on the company's financial picture. Delay in recovery thus acts as a disincentive to construction which might otherwise be done." PT-2 at 19. If New Jersey American is granted a DSIC, they will be able to receive almost immediate rate recognition for DSIC-eligible investments, but will still have to wait until a future base rate case to receive rate recognition for investments that are not eligible under DSIC. The incentive to invest in DSIC-eligible plant is evident. Indeed, Mr. Woods testified that a DSIC "would distort the program of project prioritization described by Ms. Chiavari." RC-1 at 26. The possibility that DSIC may distort the Company's project planning process is yet another reason for the Board to reject the DSIC requested in this case.

V. THE BOARD IS LEGALLY REQUIRED TO FOLLOW STATUTORY AUTHORITY AND CASE PRECEDENT WHICH DISALLOWS IMPLEMENTATION OF A DSIC.

A. DSIC Violates The Prudence Principle of Utility Ratemaking.

In examining base rate petitions, courts and regulatory agencies have long followed the prudence principle in evaluating a utility's capital investments. Under this principle, a utility is only allowed the opportunity to earn a return on the reasonable costs of a prudently made investment. This Board has stated that "only reasonable costs can be included in rate base and permitted to earn a return." *I/M/O Pub. Serv. Elec. & Gas Co. For An Increase in Rates – Hope Creek Proceeding*, BPU Docket No. ER85121163, 65 (Order dated April 6, 1987); *accord Pub. Serv. Coordinated Transp.*, 5 N.J. 196, 222 (1950). The prudence of capital investments is determined in a base rate case. Utilities are required to first make capital investments, and face regulatory scrutiny of those investments during a future base rate proceeding. If an investment is determined to have been imprudent, and/or the costs to have been unreasonable, all or part of the capital investment may be excluded from rate base. Regulatory scrutiny of its capital investments represents a business risk to a utility, one of many risks that are factored into its authorized equity return.

A utility is permitted to earn a return on its investment only once an investment has been determined to be prudent. This point is very important. This Board has never authorized a utility to earn a return on capital investments at its authorized equity return rate before the Board has scrutinized the prudence of those investments and the reasonableness of the associated costs. Yet that is exactly what New Jersey American proposes to do with its DSIC. The Board will violate the prudence principle if it allows

New Jersey American to implement the DSIC. The DSIC will allow the Company to earn a return of and on its investment almost immediately after completing construction, before the prudence of the investment and reasonableness of the costs are evaluated. This goes against traditional ratemaking principles and precedent established by this Board and our State courts. This Board has long held that only reasonable costs of prudently made investments are permitted to earn a return. The DSIC bucks this longstanding principle, and should be denied.

B. New Jersey Statutory Law Does Not Allow a DSIC To Be a Permanent Component of a Utility's Rates.

New Jersey American is proposing the DSIC to be a permanent component of the rates it charges to customers. Although the DSIC will reset to zero during the Company's next base rate case, the DSIC will not disappear. To the contrary, the Company will be free to begin charging new quarterly DSIC rates again. There are no proposed circumstances that would cause the DSIC to be eliminated; once this Board approves the clause, it will continue indefinitely. The DSIC clause will be a permanent part of the rates charged to customers, and unlike LEACs, LGACs, etc., will always involve a rate increase. This is simply not allowed under New Jersey statutory law, for the reasons described below.

The New Jersey Legislature has granted the Board the authority to increase rates outside of a full rate case only in two limited circumstances. The first exception is delineated in N.J.S.A. 48:2-21.2. This statute permits an abbreviated rate proceeding, where the Board is allowed to increase rates without making a finding of rate base in three situations: (a) if operating expenses plus depreciation plus taxes exceed the utility's

revenues for the twelve months preceding the initiation of the proceeding, and the revenue under the proposed increased rates will not exceed operating expenses, depreciation and taxes; or (b) if gross operating revenue exceeds the depreciated book value of a utility's used and useful property; or (c) if a product or service is a new offering and not covered by an existing rate or charge. N.J.S.A. 48:2-21.2. None of these three situations apply to New Jersey American's DSIC petition, nor does the Company make such a claim.

The second statute that allows rate increases outside of a full rate case is N.J.S.A. 48:2-21.1, which is titled "Adjustment of rates during pendency of hearing." This statute provides that:

The Board may, during the pendency of any hearing instituted by it, on its own initiative or on petition, in which the approval or fixing of just and reasonable individual rates...is in issue, or at any other time, negotiate and agree with any public utility for an adjustment of the individual rates....Such adjustment may be for, or without, a specified limit of time. In no event shall any such adjustment be regarded as contractual.

This statute is known as the "negotiation statute," and rate increases granted under this statute are regarded as temporary. *In Re Industrial Sand Rates*, 66 N.J. 12, 20 (1974).

Indeed, the "vital justification for the 'negotiation statute' and the rates established under it, temporarily bypassing the establishment of rate base and fair rate of return, rests upon the legal umbilical cord which ties them to the anticipated eventual determination of these fundamentals...." *Id.* at 19-20.

New Jersey American's proposed DSIC does not fit within the criteria for a rate increase under N.J.S.A. 48:2-21.1. First, the DSIC is not properly tied to a base rate case. Although the DSIC rate will be rolled into base rates and the DSIC will reset to zero in a base rate case, there is no guarantee as to when the Company will file a base rate case.

Although the Company has represented that it intends to file frequent rate cases, the permanent, ongoing nature of a DSIC does not provide a sufficient nexus to a base rate case to satisfy the statute. Secondly, the Legislature did not intend this statute to authorize on-going, permanent clauses to supplement a utility's earnings between rate cases. The statute is more appropriately used for one-time increases, for example, during an inordinately lengthy base rate case and/or ensuing appeal. *In Re Industrial Sand Rates*, 66 N.J. at 20. Adjustment clauses previously implemented by the Board are generally temporary, following the intent of the Legislature. The PSTAC and PWAC clauses provide good examples. Initially, in order to receive a PWAC or PSTAC, a water or sewer utility must show that the utility's purchased water or sewer treatment costs exceed ten percent of the utility's operating and maintenance expenses. N.J.A.C. 14:9-7.3(a) (1). When an initial PSTAC or PWAC is established, it is only effective until a company's next base rate case. N.J.A.C. 14:9-7.3(e). This is very different from a DSIC, which apparently will continue forever. N.J.S.A. 48:2-21.1 was not intended to be used for implementation of an on-going adjustment clause.

The proposed DSIC does not meet the statutory criteria for a rate increase outside of a base rate case, and should be rejected.

C. The DSIC Is Distinguishable From Adjustment Clauses That The Board Has Previously Approved.

New Jersey American may try to argue that its DSIC is legally sound by pointing to other adjustment clauses that the Board has approved in the past. The Company notes that the Board has adopted clauses such as the LEAC, PWAC, PSTAC, Remediation Adjustment Clause, Basic Gas Supply Service ("BGSS"), etc. PRT-1 at 4. New Jersey

American's attempt to compare its proposed DSIC to these clauses is a red herring. All of the clauses that New Jersey American cites are distinguishable from the DSIC, and therefore not relevant to a discussion of DSIC.

As noted previously, this Board has approved single-issue ratemaking for very large expense items only. These clauses, such as the LEAC and PWAC, are a pass-through of expenses by the Company; there is no profit element to these clauses. In contrast, the DSIC provides for a return on investment, including a profit in the form of a return on equity. This is important for several reasons. First, there is the potential for over-earning that was discussed earlier. Second, because the DSIC involves a return of and on capital investments, the DSIC will always involve a rate increase. This is different from the other adjustment clauses this Board has previously authorized. The LEAC and BGSS filings, for example, sometimes involve rate decreases. Savings are passed on to customers as quickly as price spikes are. The potential for rate decreases offers some justification for the adjustment clause. *See I/M/O the Board's Consideration of a Rate Adjustment Clause For Sewer Util. to Recover Sewage Treatment Expenses & For Water Util. to Recover Purchased Water and Power Expenses Through a Generic Proceeding*, BPU Docket No. WX8706-0524, Order dated 7/29/87, at p. 2 (in initiating a generic proceeding to explore the possibility of adopting PWAC and PSTAC clauses for the water and sewer utilities, the Board noted "that any decreases as well as increases in the above expenses would be reflected in rates in a more timely fashion.") The DSIC, in contrast, will never involve a rate decrease. The DSIC simply shifts the Company's business risk to the Company's ratepayers, with no corresponding added benefit. Additionally, unlike the DSIC, the adjustment clauses are not necessarily permanent. For

example, the PWAC is approved for a one year period, subject to an annual true-up mechanism, and ends whenever a company files a base rate case. If a company wishes to re-establish the PWAC, it must prove that the company's purchased water costs exceed ten percent of the company's operating and maintenance expenses. N.J.A.C. 14:9-7.3(a), (e).

The Company also points to the Board's order in a recent Elizabethtown Gas Company case, *I/M/Q Pivotal Utility Holdings d/b/a Elizabethtown Gas Co. to Establish a Pipeline Replacement Program Cost Recovery Rider*, BPU Docket No. GR05040371, Order dated 8/18/06 ("Elizabethtown Order"). PRT-1 at 4. This attempt by the Company to compare its proposed DSIC to the Elizabethtown Order is flawed and misleading. The Company refers to the "Elizabethtown Gas Company Incremental Pipeline Replacement Clause" in its surrebuttal testimony. PRT-1 at 4. First of all, there is no such thing as an Elizabethtown Gas Company Incremental Replacement Clause. The Board did not adopt any such clause in the Elizabethtown Order. The Elizabethtown decision, if anything, offers Board precedent for denying New Jersey American's request for a DSIC.

In that case, Elizabethtown filed a petition seeking to implement a clause to recover the costs associated with accelerated replacement of its 8 inch and 12 inch cast iron mains. The case eventually resulted in a stipulation, which the Board adopted, pursuant to which the Board specifically ordered Elizabethtown to not implement its proposed adjustment clause. *Elizabethtown Order*, BPU Docket No. GR05040371 at 2. Instead the Board allowed Elizabethtown to defer certain limited costs associated with replacing the mains. Specifically, Elizabethtown received Board authorization to defer the depreciation expenses (return of investment) plus carrying costs on certain

incremental pipeline replacement investments for a limited time period (2007 and 2008) and for a limited amount. The carrying costs did not include any profit element as they were set equal to the return on a seven year Treasury security plus sixty basis points, which rate at that time was 4.53%. *Id.* The deferral was also subject to an earnings cap of ten percent. *Id.* at 3. In granting this deferred accounting, the Board noted that Elizabethtown was subject to a base rate case stayout provision of five years. *Id.* at 4. Furthermore, unlike the DSIC, the duration of the deferred accounting was finite and ended in 2008. *Id.* at 3. The specifics of the Elizabethtown Order illustrate the Board's unwillingness to implement adjustment clauses for capital improvements, and support the denial of New Jersey American's DSIC request.

D. If the Board Wishes To Explore the Possibility of Implementing a DSIC For the Water Industry, It Should Be Done By Way of a Rulemaking, or a Generic Proceeding.

The record evidence in this case shows overwhelmingly that New Jersey American does not need a DSIC to adequately maintain its infrastructure. Rate Counsel urges the Board to deny New Jersey American's request for a DSIC. Moreover, given the broad policy issues implicated by the DSIC, it would be inappropriate for this Board to establish a DSIC for the first time in this adjudicatory proceeding. The Board should only consider a DSIC in the context of a generic proceeding or an administrative rulemaking.

DSIC involves an adjustment clause that would allow a utility to automatically increase rates to earn a return of and on capital investment without a full rate case. DSIC is a novel concept in New Jersey, and implicates broad policy issues of first impression.

There are numerous stakeholders who will be affected by the Board's position on DSIC, including large and small water utilities, public interest groups, government agencies, and senior citizens' groups. Gas and electric utilities are also interested stakeholders in that they may wish to eventually seek Board approval for a similar clause for their industries. Given the precedent that could be established, DSIC is most appropriately decided in a generic proceeding, where all interested stakeholders can participate in the process. This is the path that the Board previously followed when it considered implementing Purchased Water and Purchased Sewer Treatment Adjustment Clauses for the water and sewer companies in 1987. In that instance, several water and sewer companies had separately petitioned the Board for adjustment clauses to pass through the cost of purchased water and purchased sewer treatment. Rather than act on the companies' individual requests in separate adjudications, the Board issued an order initiating a generic proceeding to investigate the appropriateness of such clauses. *I/M/O the Board's Consideration of a Rate Adjustment Clause For Sewer Util. to Recover Sewage Treatment Expenses & For Water Util. to Recover Purchased Water and Power Expenses Through a Generic Proceeding, supra.* Later, the Board memorialized the rules governing such clauses through a rulemaking process. See N.J.A.C. 14:9-7.1 *et seq.*

While the Board may institute a generic proceeding on DSIC, it cannot do so within this docket. The only party who could potentially receive relief in this matter is New Jersey American. This proceeding involves a petition and evidence in the record by New Jersey American only, and the question before the Board is limited to whether or not New Jersey American has met its burden of proof that implementation of a DSIC is

necessary and proper. Thus, to institute a generic proceeding, the Board would have to create a record to address the generic policy issues implicated by the DSIC.

Rate Counsel maintains that ultimately the appropriate procedure to address these issues would be to institute a rulemaking. *Metromedia v. Dir., Div. of Taxation*, 97 N.J. 313 (1984). In *Metromedia*, the New Jersey Supreme Court invalidated a determination made by the Director of the Division of Taxation, finding that the agency action constituted *de facto* rulemaking that did not comply with the requirements of the Administrative Procedure Act (“APA”). *Id.* at 338. In arriving at its decision, the Court set forth the criteria for when administrative determinations constitute rulemaking rather than adjudication. These elements, if present, define an administrative action as a rule even if the agency action was done via adjudication. *Id.* at 328.

An agency determination is considered an administrative rule subject to the requirements of the APA if “many or most” of the following six features are present:

- (1) the determination has wide coverage encompassing a large segment of the regulated or general public, rather than an individual or a narrow select group;
 - (2) the determination is intended to be applied generally and uniformly to all similarly situated persons;
 - (3) it is designed to apply only to future cases;
 - (4) it prescribes a legal standard or directive that is not otherwise expressly provided by or clearly and obviously inferable from the enabling statutory authority;
 - (5) it reflects an administrative policy that (i) was not previously expressed in any official agency adjudication or rule, or (ii) constitutes a material change from a past agency position on the identical subject matter; and
 - (6) reflects a decision on administrative regulatory policy in the nature of the interpretation of law or general policy.
- Id.* at 331-32.

All six *Metromedia* factors are not required to be present for an agency action to constitute rulemaking, and the factors should be weighed, not tabulated. *I/M/O Request*

For Solid Waste Utility Customer Lists, 106 N.J. 508, 518 (1987). For a rulemaking, the APA requires proper notice to the public, broad participation of interested parties, presentation of views to the public, and the opportunity to comment on the proposed agency action, none of which has occurred here. *Metromedia, supra*, 97 N.J. at 331; N.J.S.A. 52:14B-4.

Based on *Metromedia*, even if the Board addresses the DSIC in a generic proceeding, a rulemaking would ultimately be required. The NAWC has filed generic DSIC testimony in an attempt to secure a generic DSIC order to the benefit of the NAWC's member utilities. As noted, the record in this case cannot support generic relief. This proceeding involves a request for relief by New Jersey American only. If the Board wishes to address the issues raised by the NAWC and the broader policy issues raised by a DSIC, the Board should institute a generic proceeding and/or a rulemaking.

VI. AUTHORIZING A DSIC FOR NEW JERSEY AMERICAN IS INAPPROPRIATE DURING THESE DIFFICULT ECONOMIC TIMES.

Without question, New Jersey residents are experiencing very difficult economic times. The State is feeling the effects of the downturn on Wall Street, with mounting job losses, declining home values and shrinking investment accounts. While the Board cannot solve this problem, the Board can help ratepayers avoid the automatic quarterly rate increases that will accompany a DSIC by denying New Jersey American's petition. The negative economic impact of a DSIC on ratepayers far outweighs the alleged benefits of such a clause.

The advantage of being a regulated utility like New Jersey American is that if a utility's expenses increase or revenues decrease, the utility has the option of filing a base rate petition at the Board. New Jersey American is still fully regulated by the Board, has no competition and a captive customer base. New Jersey American is insulated from extreme economic downturns like the one its ratepayers are currently experiencing. Mr. Henkes offered the following testimony on this point during the evidentiary hearings:

I would also note again in this economic meltdown that we are currently experiencing – and it only appears to be getting worse every day – a regulated utility with a monopoly franchise is in a pretty good position as compared to companies in other industries. However this cannot be said of the company's captive ratepayers. They are faced with rampant, out-of-control job losses that get worse every month and are experiencing plunging home values and retirement funds that are quickly disappearing.

These same ratepayers have already suffered through three large New Jersey American base rate increases since 2004 that cumulatively amount to almost a 42 percent increase on a compounded basis. The last increase occurred just recently in December 2008....

So New Jersey American Water Company's ratepayers have already carried a very heavy burden and now is not the time to force them to fund additional automatic quarterly rate increases through the proposed DSIC rate mechanism. Given this situation, it is now more than ever that the ratepayers need relief from ever increasing utility rates.
28T:L20 - 29T:L20 (3/6/09).

New Jersey American received rate increases of 15.19% in 2008, 12.46% in 2007, and approximately 10% in 2004. The Company has annual filings for its PWAC and PSTAC. The PWAC and PSTAC eliminate the Company's financial exposure in these areas. In a nutshell, New Jersey American is significantly better situated to weather this economic storm than are its captive ratepayers. Unlike New Jersey American, ratepayers cannot petition the Board for relief if they experience a financial squeeze. It would be unjustifiable to grant a DSIC to New Jersey American in light of today's current

environment of increasing job losses, plunging home values, and continued instability in the financial markets.

It is clear that times have changed since New Jersey American filed this petition in May of last year. The economy has declined sharply. Employees across the nation – those who are lucky enough to still have jobs – are being asked to participate in shared sacrifice. This is simply not the time for New Jersey American to be asking for extraordinary rate relief in the form of a DSIC mechanism.

CONCLUSION

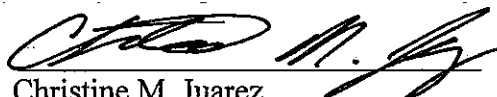
For the reasons discussed above, the Division of Rate Counsel recommends that the Board issue an order denying New Jersey American's request for a DSIC.

Respectfully submitted,

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